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Handling Losses and Excess Deductions in an Estate (or in a Trust Succeeding to an Estate)

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Handling Losses and Excess Deductions in an Estate (or in a Trust Succeeding to an Estate)

-by Neil E. Harl*

The down-turn in the economy in recent years combined with increased use of the trust have combined to draw attention to the handling of net operating losses,¹ capital losses² and deductions in excess of gross income³ in estates and in trusts succeeding to an estate.⁴ Typically, a substantial component of the excess deductions is deductions for trustee's fees and attorney's fees paid late in estate settlement.

Claiming deductions for losses and excess deductions in an estate or trust

The statute is fairly clear that if an estate, on termination of the estate, has a net operating loss carryover⁵ or a capital loss carryover,⁶ the carryover amounts are deductible by the beneficiaries succeeding to the property of the estate.⁷ Likewise, if the estate has a deduction in excess of gross income *for the last taxable year of the estate* (except for the deduction for the personal exemption⁸ and the deduction for deductions paid or set aside for a charitable purpose⁹) a deduction can be claimed also by the beneficiaries succeeding to the property of the estate.

The rules are similar on termination of a trust.¹⁰ Thus, operating loss carryovers, capital loss carryovers and, for the last taxable year of the trust, deductions in excess of gross income (with the same two exceptions as for estates,¹¹) deductions can be claimed by the beneficiaries succeeding to the property of the trust.¹²

Thus, for both estates and trusts, the heirs, residuary beneficiaries of a testate estate and remainder holders of a trust are the persons eligible to claim the deductions for carryover losses and, for the last taxable year with exceptions, the amounts for deductions in excess of gross income.¹³ The regulations and a 1960 ruling¹⁴ refer to "beneficiaries succeeding to the property of the estate or trust."¹⁵ It is clear that the holders of lesser interests are not eligible to claim the deduction. The 1960 ruling discusses that provision in the setting of a usufruct under the civil law.¹⁶

What about estates followed by a trust?

The statute on losses¹⁷ does not deal specifically with the situation where an estate is followed by a trust which is or has become a testamentary trust. However, a 1957 ruling provides guidance for situations involving excess deductions (no mention in the ruling for loss carryovers).¹⁸ Under that ruling, *Rev. Rul. 57-31*,¹⁹ if a testamentary trust has deductions in excess of its gross income *after the allowance of deductions from an estate*

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made available through I.R.C. § 642(h), the amount in excess of the gross income is not deductible by the income beneficiary or beneficiaries of the trust.²⁰ However, if the trust also terminates during the taxable year in which it is allowed the Section 642(h) deductions, the deductions in excess of gross income are available to the remainder holders succeeding to the property.²¹ Again, the deductions would be allowable to “beneficiaries succeeding to the property of the trust” but not to those with a mere income interest.²²

What if a trust beneficiary has the power to terminate the trust and, in fact, does so, in whole or in part, during the taxable year in which it is allowed the deductions allowed under I.R.C. § 642(h)? It would seem that the deductions should be allowed to the trust to that extent.

Excess deductions as itemized deductions

It appears that the beneficiaries can claim the deductions only for the taxable year in which or with which the trust (or estate) terminates. If the deductions exceed the gross income, the excess may be carried over to a later year.²³ Unused excess deductions for some expenses may be subject to the two percent floor.²⁴ The future of the proposed regulations remains unclear inasmuch as the proposed regulations were issued before the Supreme Court decision in *Rudkin*. Thus, excess deductions subject to the two-percent limit can be taken only to the extent that a beneficiary’s total miscellaneous itemized deductions exceed two percent of the beneficiary’s adjusted gross income *if the deductions are subject to the two percent limitation*.

Passive activity losses

Passive activity losses distributed by an estate or trust are not allowable as a deduction “. . . for any taxable year.”²⁵ Rather, the income tax basis of the interest distributed is increased by the amount of the passive activity losses allocable to that interest.²⁶

ENDNOTES

¹ I.R.C. § 172.

² I.R.C. § 1222.

³ I.R.C. § 642(h).

⁴ Rev. Rul. 57-31, 1957-1 C.B. 201. See generally 2 Harl, *Farm Income Tax Manual* § 4.03 (2010 ed.).

⁵ I.R.C. § 172.

⁶ I.R.C. § 1212.

⁷ I.R.C. § 642(h).

⁸ I.R.C. §§ 642(b), 642(h)(2).

⁹ I.R.C. §§ 642(c), 642(h)(2).

¹⁰ I.R.C. § 642(h).

¹¹ See notes 8 and 9 *supra*.

¹² I.R.C. § 642(h).

¹³ See Treas. Reg. § 1.642(h)-3.

¹⁴ Rev. Rul. 60-134, 1960-1 C.B. 259.

¹⁵ Treas. Reg. § 1.642(h)-3.

¹⁶ Rev. Rul. 60-134, 1960-1 C.B. 259.

¹⁷ I.R.C. § 642(h).

¹⁸ Rev. Rul. 57-31, 1957-1 C.B. 201.

¹⁹ 1957-1 C.B. 201.

²⁰ Rev. Rul. 57-31, 1957-1 C.B. 201.

²¹ I.R.C. § 642(h)(2). See Rev. Rul. 57-31, 1957-1 C.B. 201.

²² See Treas. Reg. § 1.642(h)-3.

²³ Treas. Reg. § 1.642(h)-2.

²⁴ I.R.C. § 67. See *William L. Rudkin Testamentary Trust v. Comm’r*, 128 S.Ct. 782 (S. Ct. 2008). See also Prop. Treas. Reg. § 1.67-4(a).

²⁵ I.R.C. § 469(j)(12).

²⁶ *Id.*

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor owed taxes for 1998-2006 and sought to have the taxes declared dischargeable in a bankruptcy case filed in 2009. The debtor filed all the returns late, filed multiple bankruptcy cases from 2005 through the present case, made several low offers in compromise, provided false information to the IRS, placed assets in the names of other persons, and initiated

several other tax proceedings. The debtor was employed during these years and had ample income to pay the taxes but spent the money on a residence and placed funds in a retirement account. The court found that the debtor had done most of these activities with the intent to hinder or delay the IRS collection of the taxes owed; therefore, the taxes were nondischargeable under Section 523(a)(1)(C) for willful attempts to evade or defeat taxes. *In re Acker*, 2010-2 U.S. Tax Cas. (CCH) ¶ 50,636 (E.D. Texas 2010).